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Draft Guide to Enactment of the UNCITRAL Model Law on Secured Transactions

Note by the Secretariat

Addendum

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Chapter V. Priority of a security right

A. General rules

Article 29. Competing security rights created by the same grantor

1. Article 29 is based on recommendation 76 of the Secured Transactions Guide (see chap. V, paras. 45-54). It addresses priority as between security rights created by the same grantor. Article 29 divides the priority competitions it addresses into three categories. First, it addresses priority as between competing security rights made effective against third parties by registration of a notice in the Registry. Second, it addresses priority as between competing security rights made effective against third parties by a method other than registration of a notice in the Registry. Third, it addresses priority as between competing security rights, one (or more) of which was made effective against third parties by registration of a notice in the Registry and the other one (or more) was made effective against third parties by a method other than registration of a notice in the Registry.

2. The first category, set out in paragraph 1 (a), addresses the most common situation, that is, priority competitions between security rights made effective against third parties by registration of a notice in the Registry. In that situation, priority is determined by the order of registration. This provides a simple and easy-to-apply rule, in which all of the information necessary for the priority determination is maintained by the Registry and is easily determinable by the parties and competing claimants.

3. It should be noted that the priority rule in paragraph 1 (a) applies even if one or more of the competing security rights had not been created at the time of registration (registration of a notice may precede creation of a security right; see art. 4 of the Model Registry Provisions) and, thus, were not effective against third parties at the time of registration (inasmuch as a security right that has not yet been created cannot be effective against third parties).

4. To illustrate this aspect of the rule in paragraph 1 (a), assume that: (a) on Day 1, Grantor authorized SC 1 to register a notice listing Grantor as the grantor and describing the encumbered assets as all present and future equipment of Grantor, and SC 1 registered the notice; (b) on Day 2, Grantor borrowed money from SC 2 and created in favour of SC 2 a security right in all of Grantor's present and future equipment and SC 2 registered a notice with respect to that security right; and (c) on Day 3, Grantor borrowed money from SC 1 and created in favour of SC 1 a security right in all of Grantor's present and future equipment. In this case, the security right of SC 2 became effective against third parties before the security right of SC 1 (because SC 1's security right did not become effective against third parties until it was created). Yet, as a result of the rule in paragraph 1 (a), in determining the priority between the security rights of SC 1 and SC 2, the time of registration of SC 1's notice, rather than the later time on which SC 1's security right became effective against third parties, is used. Thus, the security right of SC 1 has priority over the security right of SC 2 because the notice with respect to the security right of SC 1 was registered on Day 1 before the security right of SC 2 became effective against third parties on Day 2.

5. The rule in paragraph 1 (a) is beneficial for two reasons. First, as a result of this rule, the priority of security rights that are made effective against third parties

by the registration of a notice will always be determined according to the time of registration. The time of registration is maintained by the Registry and is, therefore, easy to demonstrate and easy to search. By way of contrast, the creation of a security right is a private event between the grantor and the secured creditor; the time of creation is not maintained by the Registry and is not publicly available and may be difficult to establish.

6. Second, the results that follow from the application of the rule in paragraph 1 (a) are consistent with the behaviour of prudent secured creditors. For example, assume that SC 2 is considering extending credit to Grantor, secured by a security right in an item of Grantor's equipment. If SC 2 searches the records of the Registry and discovers that a notice has been registered listing Grantor as the grantor and SC 1 as the secured creditor and indicating that the encumbered asset is the same item of equipment, SC 2 will not know whether SC 1 has a security right or, rather, has registered a notice before creation of the security right. In such a situation, SC 2 would likely make the conservative assumption that the registered notice reflects an existing security right and, accordingly, if SC 2 decides to go forward with the transaction, it will be with the understanding that its rights are subordinate to that of SC 1. The rule in paragraph 1 (a) is consistent with the behaviour of SC 2.

7. The second category of priority competitions is addressed in paragraph 1 (b). In cases in that category, neither security right has been made effective against third parties by registration of a notice in the Registry. In that situation (which is not very common inasmuch as situations in which two different secured creditors are both able to make their security rights effective against third parties by a method other than registration are not common), priority is determined by the order of third-party effectiveness.

8. In the third category of priority competitions, one (or more) security right has been made effective against third parties by registration of a notice in the Registry and the other one (or more) security right has been made effective against third parties by another method (such as by possession of the encumbered asset). In this category, the time of registration of a security right made effective against third parties by registration is compared to the time of third-party effectiveness of a security right made effective against third parties other than by registration, and the security right with the earlier time of registration or third-party effectiveness has priority.

9. The result of the rules in paragraphs 1 (a) and 1 (c) is that the priority of a security right made effective against third parties by registration of a notice in the Registry will be determined by the time of registration (without regard to the time at which the security right was created), whether the competing security right was made effective against third parties by registration or by another method. This means that, once a secured creditor has registered a notice with respect to a security right, that secured creditor will be able to determine its priority with respect to all competing security rights whose priority is determined by the rules in this article.

10. In cases in which a secured creditor has taken steps to make its security right effective against third parties by more than one method (such as when a secured creditor, who has possession of an encumbered asset, subsequently registers a notice with respect to that security right in the Registry, or vice versa), the time of the earlier event should be used in applying the rule in article 29, unless there is a

subsequent "gap" during which the security right is neither effective against third parties nor the subject of a notice registered in the Registry (see art. 31).

Article 30. Competing security rights created by different grantors

11. Article 30 addresses priority as between security rights in the same encumbered asset that were created by different grantors. This situation can occur, for example, if a grantor creates a security right in its equipment in favour of a secured creditor and then transfers the equipment to a transferee who creates a security right in it in favour of a different secured creditor. In this situation, article 30 provides that the same rules apply as those that apply when the same grantor has granted both of the competing security rights (see art. 29), except as provided in article 26 of the Model Registry Provisions, which provides three alternatives to States (see A/CN.9/WG.VI/WP.71/Add.3, paras. 48-53).

Article 31. Competing security rights in the case of a change in the method of third-party effectiveness

12. Article 31 addresses situations in which there has been a change in the method of third-party effectiveness. This may happen, for example where a secured creditor in possession of the encumbered asset returns possession of it to the grantor after registering a notice with respect to it in the Registry. In such a case, the priority of the security right is determined by the time at which the security right initially became effective against third parties so long as there was no time thereafter during which the security right was not effective against third parties.

Article 32. Competing security rights in proceeds

13. Article 32, which is based on recommendation 100 of the Secured Transactions Guide (see chap. V, paras. 144-150), is important because, in many cases in which two secured creditors have a security right in the same asset, one or both of those security rights exist because that asset constitutes proceeds of a different encumbered asset in which the secured creditor had a security right and which the grantor has sold. Situations in which a secured creditor has a security right in proceeds are quite common when the original encumbered asset was inventory or a receivable inasmuch as a grantor will frequently sell the inventory or collect a receivable before satisfaction of the obligation secured by that asset. In such a case, the security right continues in the proceeds as provided in article 10 and the security right in the proceeds is effective against third parties if the conditions in article 19 are satisfied. This article determines the priority of that security right in an encumbered asset as proceeds as against another secured creditor with a security right in the same encumbered asset, whether as original encumbered asset or as proceeds. Under this article, the priority of the security right in the proceeds is the same as the priority of the security right in the original encumbered asset.

14. Thus, for example, assume that: (a) on Day 1, Grantor creates in favour of SC 1 a security right in all of Grantor's present and future inventory and SC 1 registers a notice with respect to that security right; (b) on Day 2, Grantor creates in favour of SC 2 a security right in all of Grantor's present and future receivables and SC 2 registers a notice with respect to that security right; and (c) on Day 3, Grantor sells some of its inventory on credit, generating a receivable. SC 2 has a security right in that receivable because of its security right in present and future receivables, while

SC 1 has a security right in that receivable because it is proceeds of the inventory in which SC 1 had a security right. SC 1's security right in the receivable has priority over SC 2's security right because the priority of SC 1's security right in the receivable as proceeds is determined utilizing the time of third-party effectiveness or registration of notice with respect to the security right in the inventory, whichever came first (see art. 29). Thus SC 1's priority in the receivable dates from Day 1, while SC 2's priority in the receivable dates from Day 2 (for security rights in proceeds of acquisition security rights, however, see art. 41).

Article 33. Competing security rights in tangible assets commingled in a mass or transformed into a product

15. Article 33 addresses two priority issues resulting from situations in which one or both of the competing security rights is a security right that continued in (or extended to) a mass or product because the original encumbered asset was commingled in that mass or transformed into that product (see Secured Transactions Guide, chap. V, paras. 117-124 and recs. 90 and 91). First, paragraph 1 addresses situations in which the competing security rights were in the same encumbered asset and that asset became part of a mass or product. In that case, the order of priority of the security rights in the mass or product is the same as the order of priority of the security rights in the original encumbered asset. Second, paragraphs 2 and 3 address situations in which the competing security rights were originally in different encumbered assets and all of those encumbered assets became part of the same mass or product. In such a case, if the value of the two security rights in the mass or product, as determined in article 11 (see A/CN.9/WG.VI/WP.71/Add.1, paras. 66-68), is insufficient to satisfy the secured obligations, the secured parties share the aggregate maximum value of their security rights in same proportion as the ratio of the value of the security rights in the mass or product.

Article 34. Security rights competing with rights of buyers or other transferees, lessees or licensees of an encumbered asset

16. Article 34 is based on recommendations 79-82 of the Secured Transactions Guide (see chap. V, paras. 60-89). It determines the rights of a buyer or other transferee, lessee or licensee of an encumbered asset vis-à-vis the security right. The general rule, which is stated in paragraph 1 and is subject to important exceptions stated in paragraphs 2-6, is that a security right in an encumbered asset that is effective against third parties continues to encumber the asset notwithstanding the sale or other transfer, lease or licence of the encumbered asset. The article provides two types of exceptions to the general principle stated in paragraph 1. Paragraphs 2 and 3 provide exceptions based on the actions of the secured creditor, while paragraphs 4-6 provide exceptions based on the nature of the sale, lease or licence and the knowledge of the buyer, lessee or licensee.

17. Paragraph 2 provides that, if the secured creditor authorizes the sale or other transfer of the encumbered asset free of the security right, the buyer or other transferee acquires its rights in the asset free of that security right. The rule in this paragraph fulfils the intention of the parties inasmuch as the secured creditor has, by its authorization, evidenced intent for the general rule in paragraph 1 not to apply. Such an authorization may be given in the security agreement or separately. It may be given when, for example, a sale or other transfer of an encumbered asset free of

the security right would generate proceeds that the grantor can use to satisfy the secured obligation, but a sale or other transfer subject to the security right would generate a smaller amount of proceeds and thus result in the satisfaction of a smaller part of the secured obligation. Paragraph 3 brings about the same result in the case of a lease or licence of the encumbered asset. It is stated differently than the rule in paragraph 2 because some, but not all, States do not characterize the rights of a lessee or licensee as property rights.

18. Paragraphs 4-6 provide that a buyer (not a transferee without consideration), lessee, or licensee of a tangible encumbered asset (but not reified intangibles, such as money, negotiable instruments, negotiable documents and certificated non-intermediated securities; see art. 2, subpara. (ll)) in a transaction in the ordinary course of business of the seller, lessor or licensor acquires its rights in that asset free of the security right that encumbered it while in the hands of the seller, lessor, or licensor. Under paragraph 4, a buyer of a tangible encumbered asset (not a transferee without consideration) acquires its rights free of the security right if two conditions are satisfied. First, the sale must have been in the ordinary course of the seller's business. Thus, for example, the sale of some of a seller's inventory in accordance with the typical business practices of the seller would satisfy this condition, but an atypical sale by that seller of a used item of the seller's equipment would not satisfy this condition. The second condition is that the buyer must have acquired the encumbered asset without knowledge (as of the time of the conclusion of the agreement with the seller pursuant to which the buyer acquired the asset) that the sale violated the rights of the secured creditor under the security agreement.

19. "Knowledge" is defined in article 2, subparagraph (r), as actual knowledge. Therefore, "constructive knowledge" that the sale violated the rights of the secured creditor does not disqualify the buyer from the protection of this provision. It is also important to note that knowledge of the existence of the security right, as opposed to knowledge that the sale violated the secured creditor's rights, is insufficient to disqualify the buyer from the benefits of paragraph 4. If, for example, a buyer knows that the seller has encumbered its inventory, but does not know whether the secured creditor has authorized sales of that inventory free of the security right, the buyer has knowledge of the security right but does not have knowledge of whether the sale violated the rights of the secured creditor.

20. Paragraphs 5 and 6 bring about similar results to those in paragraph 4 in the case of leases of tangible encumbered assets and non-exclusive licences of intellectual property. As with paragraph 3, the formulation of paragraphs 5 and 6 differs from the formulation of paragraph 4, because some, but not all, States do not characterize the rights of a lessee or licensee as property rights. Paragraphs 7 and 8 state what is often referred to as a "shelter principle". Accordingly, once a buyer or other transferee, lessee, or licensee obtains rights in the encumbered asset free of (or unaffected by) a security right, those that acquire their rights in the encumbered assets from or through the buyer, lessee, or licensee are similarly free of (or unaffected by) that security right.

21. Paragraph 9 protects a buyer or lessee who acquired its rights in consumer goods that are subject to a security right before the security right was made effective against third parties by one of the methods provided in article 18. If the security right was made effective against third parties automatically as provided in article 24, a buyer or lessee of consumer goods acquire its rights subject to or affected by the

security right in the goods. It should be noted that article 24 applies to consumer goods with an acquisition price below an amount to be specified by the enacting State (see A/CN.9/WG.VI/WP.71/Add.1, paras. 94 and 95).

Rights of buyers or other transferees, lessees or licensees of an encumbered asset in the case of specialized registration

22. States that provide a specialized registry or title certificate system for achieving third-party effectiveness of a security right in particular types of asset (see A/CN.9/WG.VI/WP.71/Add.1, para. 85, and A/CN.9/WG.VI/WP.71/Add.6, para. 10) may wish to consider whether, in order to enable competing claimants that utilize the specialized registry or title certificate system to determine their rights solely by a search of the specialized registry system or examination of the title certificate, rights of such parties should be superior to the rights of a secured creditor that achieved third-party effectiveness by other means (see Secured Transactions Guide, chap. V, paras. 56 and 57, and rec. 77; for the coordination with specialized movable property registries, see Registry Guide, paras. 64-70).

Article 35. Impact of the grantor's insolvency on the priority of a security right

23. Under article 35, a security right that is effective against third parties remains effective against third parties notwithstanding the commencement of insolvency proceedings against the grantor. Moreover, nothing in the secured transactions law changes the priority of that security right as against the rights of competing claimants merely because insolvency proceedings have been commenced. Thus, unless the applicable insolvency law provides to the contrary, a security right retains the priority it had as against the rights of competing claimants before the commencement of the insolvency proceedings.

Article 36. Security rights competing with preferential claims

24. Article 36 is based on recommendations 83, 85 and 86 of the Secured Transactions Guide (see chap. V, paras. 90-93 and 103-109). It provides a framework by which the enacting State can implement the policy of these recommendations by: (a) listing in a clear and specific way any claims that will have priority over security rights; and (b) indicating a cap on the amount of the claim given priority. Once a State lists any preferential claims and their amounts in article 36, secured creditors will be positively informed and thus can take the preferential claims and their amounts into account before lending (for example, by deducting the amount of the preferential claims from the net worth of a potential grantor that can be used as security for credit). It should be noted that article 36 provides a framework for the enacting State to list claims that will have priority over security rights whether or not insolvency proceedings have been commenced with respect to the grantor. However, it does not address the issue of whether certain preferential claims have a special priority status triggered by the commencement of insolvency (see Secured Transactions Guide, rec. 239).

25. Examples of claims that some States have determined that should have priority over a competing security right and, thus, should be listed in this article, if the enacting State makes the same determination, include: (a) claims of unpaid sellers or suppliers of goods, or those who have rendered services such as repair services

with respect to goods, but only to the extent that they have retained possession of the goods; and (b) claims of employees for employment benefits.

26. It should be noted that secured creditors typically obtain representations from grantors about preferential claims. However, if a grantor does not disclose the existence of a preferential claim, the secured creditor has only an unsecured claim against the grantor for breach of contract. In any case, whether or not the grantor discloses the existence of that claim, a claim listed by the enacting State in this article has priority to the extent stated in this article.

27. It should also be noted that, in some States, preferential claims are subject to the registration of a notice in the Registry. In some of those States, the priority of preferential claims is subject to the general first-to-register priority rule. This approach is useful only if the notice registered states a maximum amount which every secured creditor may take into account before extending credit. In other States, registered preferential claims have priority even over prior registered security rights. Such registration serves only information purposes. This approach is of limited value to secured creditors (see Registry Guide, paras. 46 and 51).

Article 37. Security rights competing with rights of judgment creditors

28. Article 37 is based on recommendation 84 of the Secured Transactions Guide (see chap. V, paras. 94-102). It determines the priority as between a security right in an encumbered asset and the right of a judgment creditor that has acquired a right in the encumbered asset by taking whatever steps are necessary in order to do so under applicable law. Paragraph 1 gives priority to the right of the judgment creditor if the steps necessary for it to acquire rights in the encumbered asset occur before the security right becomes effective against third parties. The enacting State should complete paragraph 1 by inserting the relevant steps, or a reference to those steps, necessary for a judgment creditor to acquire rights in the encumbered asset. These steps may include actions such as registration of a notice in the security rights registry, seizure of assets or service of a garnishment order.

29. Paragraph 2 provides that, in cases in which the judgment creditor does not acquire its rights in the encumbered asset before the security right becomes effective against third parties, the security right has priority over the right of the judgment creditor. This rule protects a secured creditor against the possibility of having its security right be subordinate to the right of a judgment creditor that did not exist at the time the secured creditor took the steps necessary to make its security right effective against third parties. However, paragraph 2 limits the extent of that priority by providing that the priority of the security right does not extend to: (a) credit extended by the secured creditor more than a short period of time (to be specified by the enacting State) after the judgment creditor notifies the secured creditor that it has taken the steps necessary to acquire its right; or (b) credit extended thereafter pursuant to an irrevocable commitment made before that notification. This rule prevents the secured creditor from exploiting its priority status to increase the secured obligation even after the secured creditor acquires actual knowledge about the rights of the judgment creditor and has had a short period of time to adjust to the existence of those rights. Paragraph 2 also deals with the rare situation in which the judgment creditor acquired its rights in the encumbered asset “at the same time” when the security right became effective against third parties, which may occur where the encumbered assets are future assets.

Article 38. Acquisition security rights competing with non-acquisition security rights

30. Article 38 is based on recommendation 180 of the Secured Transactions Guide (see chap. IX, paras. 131, 136, 137, 143 and 146) and recommendation 247 of the Intellectual Property Supplement (see paras. 259-263). Two alternative options are provided for the enacting State. Both options provide that, under certain circumstances, an acquisition security right has priority over a competing non-acquisition security right in the same encumbered asset even if, under the general priority rule in article 29 the non-acquisition security right would have priority over the acquisition security right. When those circumstances are present, it is often said that the acquisition security right has "super-priority" over the competing non-acquisition security right.

31. "Super-priority" for acquisition security rights is a feature of the law of most States, whether phrased in terms of a higher priority for security rights securing obligations incurred in order to acquire the encumbered asset or, in many legal systems, as a necessary implication of title to the encumbered asset being retained by the seller (under art. 2, subpara. (kk), a seller's retention-of-title right is a security right). Article 38 continues this advantageous treatment of acquisition finance, providing a variety of "super-priority" rules depending on the nature of the asset that is subject to the acquisition security right. The reference to possession by the secured creditor in paragraphs 1 (a) and 2 (a) of option A and paragraph 1 (a) of option B means possession as a method of third-party effectiveness, and not possession acquired in the context of enforcement. Thus, an acquisition secured creditor who failed to register on time cannot obtain this super-priority by taking possession of the encumbered asset in the context of enforcement or otherwise if the security agreement allowed the acquisition secured creditor to do so. In other words, third-party effectiveness and priority cannot be changed upon commencement of enforcement. Otherwise, each secured creditor could change its priority by commencing enforcement, a result that would introduce great uncertainty.

32. Option A contains three "super-priority" rules. Which of the three rules is applicable in a particular case depends on the nature of the encumbered assets. If the encumbered assets are equipment or its intellectual property equivalent (that is, intellectual property or rights of a licensee under a licence of intellectual property that is primarily used or intended to be used by the grantor in the operation of its business; see art. 2, subpara. (l)), the rule in paragraph 1 applies. If the encumbered assets are either inventory or its intellectual property equivalent (that is, intellectual property or rights of a licensee under a licence of intellectual property held by the grantor for sale or licence in the ordinary course of the grantor's business; see art. 2, subpara. (q)), the rule in paragraph 2 applies. If the encumbered assets are consumer goods or their intellectual property equivalent (that is, intellectual property or rights of a licensee under a licence of intellectual property used or intended to be used by the grantor primarily for personal, family or household purposes; see art. 2, subpara. (f)), the rule in paragraph 3 applies.

33. Under the "super-priority" rule in paragraph 1 of option A, an acquisition security right in equipment or its intellectual property equivalent has priority over a competing non-acquisition security right created by the grantor, if either the acquisition secured creditor is in possession of the asset (unlikely inasmuch as most acquisition security rights are not made effective against third parties by the acquisition secured creditor maintaining possession of the asset) or a notice with

respect to the acquisition security right is registered in the Registry within a short period of time to be specified by the enacting State after the grantor obtains possession of the asset (so that registration would not delay the delivery of the assets). Thus, so long as the acquisition secured creditor registers a notice with respect to the acquisition security right within the specified period, that security right will have super-priority over a competing non-acquisition security right that was made effective against third parties even before the acquisition security right was made effective against third parties.

34. Under the super-priority rule in paragraph 2 of option A, additional requirements must be satisfied for an acquisition security right in inventory or its intellectual property equivalent to have "super-priority" over a competing non-acquisition security right. In addition to the requirements set out in paragraph 1, if the non-acquisition secured creditor has registered a notice in the Registry with respect to a security right created by the grantor in an asset of the same kind as the asset that is subject to the acquisition security right, the acquisition security right will have super-priority only if the non-acquisition secured creditor received a notice from the acquisition secured creditor. The notice must: (a) state that the acquisition secured creditor has or intends to acquire an acquisition security right; and (b) describe the asset sufficiently to enable the non-acquisition secured creditor to identify the asset that is the object of the acquisition security right.

35. There are two reasons for the additional requirements for super-priority in the case of inventory or its intellectual property equivalent. First, because inventory may "turn over" quickly and depreciate quickly, it would be economically inefficient for a potential financier considering extending credit to be secured by a non-acquisition security right in present and future inventory to need to wait for the passage of the period of time stated in paragraph 1 before being certain that the grantor's inventory is not subject to an acquisition security right that will have super-priority. The requirement that the actions required for super-priority in paragraph 2 take place before the grantor obtains possession of the encumbered asset addresses this concern. Second, inasmuch as new inventory can often be difficult to distinguish from old inventory, even a secured creditor with a security right in future inventory that monitors the assets of the grantor will not always be able to easily detect the presence of new inventory that has replaced similar older inventory. Thus, such a secured creditor may not be able to determine that some items of inventory are recently acquired and thus potentially subject to an acquisition security right. The additional notice requirement addresses this concern.

36. Paragraph 4 of option A contains two important rules about the additional notice required in paragraph 2 (b)(ii). First, such a notice may cover acquisition security rights under multiple transactions between the same parties without the need to identify each transaction. Thus, for example, a seller that is planning to engage in a series of transactions with the same grantor, under which the seller will sell inventory to the grantor subject to an acquisition security right, may send a single notice to the competing non-acquisition secured creditor generally describing the set of transactions. Second, the additional notice suffices to bring about super-priority if the grantor acquires the assets subject to the acquisition security right not later than a time period to be specified by the enacting State, such as five years, after that notice is received. As a result, a seller that provides a notice for a series of transactions in which acquisition security rights are created will not need to send

another notice with respect to assets acquired within that time period after the first notice is received.

37. Under the super-priority rule in paragraph 3 of option A, an acquisition security right in consumer goods or their intellectual property equivalent automatically has priority over a non-acquisition security right in the same encumbered asset. No additional actions are required in order for the acquisition security right to enjoy super-priority.

38. Option B contains only two "super-priority" rules. The first rule, found in paragraph 1, is identical to paragraph 1 of option A (which applies only to equipment) except that it also applies to inventory and the intellectual property equivalent of inventory. The second rule, found in paragraph 2, is identical to paragraph 3 of option A. Thus, the only difference between option A and option B is that, in the former, additional steps must be taken in order for an acquisition security right in inventory or in the intellectual property equivalent of inventory to have priority over a competing non-acquisition security right.

Article 39. Competing acquisition security rights

39. Article 39 is based on recommendation 182 of the Secured Transactions Guide (see chap. IX, paras. 173-178). It addresses the priority of competing security rights when all of them are acquisition security rights. Unlike article 38 (which gives priority to acquisition security rights that satisfy certain criteria as against non-acquisition security rights), this article addresses priority as between security rights that would otherwise be entitled to "super-priority". The rule in article 39 reflects two policy decisions. First, under paragraph 1, except in the case addressed in paragraph 2, inasmuch as competing acquisition security rights are entitled to super-priority and super-priority gives no reason to prefer one over the other, priority should be determined on the basis of the general rules applicable. Second, under paragraph 2, an acquisition security right of a seller or lessor, or a licensor of intellectual property, has priority over an acquisition security right of another person such as a lender. Thus, paragraph 2 protects the supplier of goods on credit over the lender of money because the supplier is often a small- or medium-size enterprise and the kind of credit it provides is extremely important for the economy as a whole (see para. 40 below).

Article 40. Acquisition security rights competing with the rights of judgment creditors

40. Article 40 is based on recommendation 183 of the Secured Transactions Guide (see chap. IX, paras. 145-148). Without the rule in this article, the period provided in article 38 would not be useful. The reason for this is that a secured creditor taking an acquisition security right typically would not want to have a period in which it would be vulnerable to the rights of a judgment creditor. In such a case, a secured creditor would likely register a notice before, or as soon as possible after, the security right was created. Accordingly, a secured creditor would not benefit from the longer period to register and achieve "super-priority" under article 38. Article 40 is another provision protecting the supplier of goods on credit because of the importance of this kind of credit for the economy as a whole (see para. 39 above).

41. By way of illustration, assume that Grantor acquires an item of equipment from Seller on credit on Day 1 and creates in favour of Seller an acquisition security right in the item of equipment to secure its obligation to pay the remainder of the purchase price. On Day 5 Seller registers a notice that has the effect of making its acquisition security right effective against third parties. Between those two dates, on Day 3, Judgment Creditor obtains a judgment against Grantor and takes the steps specified in article 37, paragraph 1, to acquire rights in the item of equipment. Under the rule in article 37, paragraph 1, Judgment Creditor's rights would have priority over Seller's security right because Judgment Creditor obtained its rights before Seller's security right was effective against third parties. As a result of the operation of article 40, however, Seller's security right has priority over the rights of Judgment Creditor.

Article 41. Competing security rights in proceeds of an asset subject to an acquisition security right

42. Article 41 is based on recommendation 185 of the Secured Transactions Guide (see chap. IX, paras. 158-172). Both option A and option B of article 38 provide that, under certain circumstances, an acquisition security right has priority over a competing non-acquisition security right in the same encumbered asset even if, under the general priority rule in article 29, the non-acquisition security right would have priority. This article determines whether that "super-priority" over non-acquisition security rights carries over to proceeds of the encumbered assets that are subject to the acquisition security right so that the security right in proceeds of the asset subject to an acquisition security right also has super-priority.

43. Under the general principles of article 10, a secured creditor with a security right in an asset obtains a security right in the identifiable proceeds of that asset and, under the circumstances described in article 19, that security right is effective against third parties. This is equally true of assets subject to non-acquisition security rights and those subject to acquisition security rights. Under the rule in article 32, the priority of the security right in the proceeds is the same as the priority of the security right in the original encumbered asset. Under that rule, the security right in proceeds of assets subject to an acquisition security right would have the same "super-priority" as the security right in the original encumbered asset. Article 41, however, limits the reach of article 32 by extending "super-priority" to proceeds only of certain types of asset subject to an acquisition security right (option A) or by not extending the "super-priority" to proceeds at all (option B).

44. Under option A, the "super-priority" with respect to the assets subject to the acquisition security right always carries over to the proceeds of those assets, except when the assets subject to the acquisition security right consist of inventory, consumer goods or their intellectual property equivalent. When the asset subject to the acquisition security right is inventory or its intellectual property equivalent, whether the "super-priority" carries over to proceeds depends on the nature of the proceeds. If the proceeds are receivables, negotiable instruments or rights to payment of funds credited to a bank account, the "super-priority" does not carry over to those proceeds. If, on the other hand, the proceeds take another form, the "super-priority" does carry over to the proceeds. When the assets subject to the acquisition security right are consumer goods or intellectual property, or rights of a licensee under a licence of intellectual property used or intended to be used by the grantor primarily

for personal, family or household purposes, however, the "super-priority" does not carry over to the proceeds.

45. The primary reason for the decision not to provide "super-priority" for certain types of proceeds in option A relates to the difficulty that would be faced by competing secured creditors with security rights in payment rights in determining which of those payment rights are proceeds of assets subject to acquisition security rights and which are not. As a result, if there were "super-priority" treatment for those types of proceeds, competing secured creditors with security rights in payment rights might simply assume that all of those payment rights are proceeds and, as a result, extend less credit on the basis of them.

46. Option B provides that the "super-priority" with respect to assets subject to an acquisition security right does not carry over to proceeds of those assets under any circumstances, with the result that the priority of the security right in the proceeds will be determined under the general principle in article 29. This option is provided as an option for States that do not wish to make the sort of distinctions between types of proceeds made in option A.

47. As the Model Law does not deal with insolvency-related matters, with the exception of article 35 (see para. 23 above), no article has been included in the Model Law along the lines of recommendation 186 of the Secured Transactions Guide to deal with the application of the special priority rules for acquisition security rights. However, there is nothing in these articles to imply that insolvency law will not operate against the background of secured transactions law and thus that these provisions will not apply to acquisition security rights in the case of insolvency.

Article 42. Acquisition security rights extending to a mass or product competing with non-acquisition security rights in the mass or product

48. Article 42 deals with situations in which a grantor has created an acquisition security right in an asset that later becomes part of a mass or product and has also created a security right in the mass or product. Under article 11, when the original asset becomes part of the mass or product, the secured creditor has a security right in that mass or product, subject to the limits set forth in that article. Article 42 provides that the security right in the mass or product that results from the acquisition security right in the separate asset has priority over the security right in the mass or product as an original encumbered asset, even if the latter security right would otherwise have had priority under the rules in article 29.

Article 43. Subordination

49. Article 43 is based on recommendation 94 of the Secured Transactions Guide (see chap. V, paras. 128-131). Paragraph 1 allows a person to agree to lower priority of its security right as against a competing claimant than would otherwise result from application of the priority rules in this chapter.

50. Such an agreement, usually referred to as a subordination agreement, may be in the form of a bilateral agreement between the party agreeing to lower priority and the competing claimant that will benefit from that agreement; it may also be a unilateral commitment (usually made to the grantor) by the party agreeing to lower priority that its priority will be lower than that of the beneficiaries described in the

commitment. Such an agreement is governed by this article so long as it is between a secured creditor and a grantor, between two or more secured creditors or between a secured creditor and another competing claimant (e.g. a judgment creditor or an insolvency representative).

51. Paragraph 2 makes it clear that, as an agreement, a subordination agreement binds only the parties to it and does not subordinate the claims of any other parties. For example, assume that three secured creditor, SC 1, SC 2 and SC 3, have security rights in the same encumbered assets, securing claims of € 50.00, € 10.00 and € 70.00, respectively. Assume further that the order of priority is SC 1, SC 2 and SC 3, and that SC 1 subordinates its claim to that of SC 3. Under the rule in paragraph 2, the effect of subordination is that SC 3 will succeed to SC 1's priority status up to € 50.00 and that SC 2's claim to the next € 10.00 will not be affected.

Article 44. Future advances and future encumbered assets

52. Article 44 is based on recommendations 97-99 of the Secured Transactions Guide (see chap. V, paras. 135-143). Inasmuch as a security right can secure obligations arising after the conclusion of the security agreement (see art. 7) and a secured obligation can be secured by assets created or acquired after the conclusion of the security agreement (see art. 8), this article clarifies the priority of a security right in such circumstances.

53. Paragraph 1 provides that the priority of a security right extends to all obligations it secures, regardless of when those obligations were incurred. Thus, a security right has the same priority over the right of a competing claimant whether the entire secured obligation was incurred at or before the creation of the security right or whether the security right secures obligations incurred thereafter. Paragraph 2 similarly provides that when a security right has been made effective against third parties by the registration of a notice, the priority resulting from the time of that notice under article 29 is the same whether the encumbered assets were owned by the grantor at the time of registration or acquired thereafter.

Article 45. Irrelevance of knowledge of the existence of a security right

54. Article 45 is based on recommendation 93 of the Secured Transactions Guide (see chap. V, paras. 125-127). A secured creditor's knowledge or lack of knowledge of a competing security right is not relevant to a determination of priority as between the secured creditor's security right and the competing security right under either the general priority rule in article 29 or any of the special priority rules. The point is made explicit in this article to emphasize that priority is determined only on the basis of the facts referred to in those priority rules and not on the basis of difficult-to-prove subjective states of knowledge. Article 45 applies only to the knowledge of the existence of a competing security right. Under the Model Law, knowledge of other facts may be relevant to priority. For example, a buyer of a tangible encumbered asset that has knowledge that the sale violates the rights of a secured creditor with a security right in that asset under the security agreement does not take free of the security right (see art. 34, para. 4).

B. Asset-specific rules

Article 46. Negotiable instruments

55. Article 46 is based on recommendations 101 and 102 of the Secured Transactions Guide (see chap. V, paras. 154-156). Differences between article 46 and recommendations 101 and 102 are of a drafting nature and are intended to ensure that paragraph 1 deals only with the relative priority of competing security rights in the same negotiable instrument, while paragraph 2 addresses the rights of a secured creditor with a security right in a negotiable instrument as against a buyer or other consensual transferee of the negotiable instrument.

56. Under paragraph 1, a security right in a negotiable instrument that is made effective against third parties by the secured creditor's possession of the negotiable instrument has priority over a security right in the same negotiable instrument that is made effective against third parties by registration of a notice, without regard to the order in which the security rights became effective against third parties. This is consistent with the important role that possession plays in the law of negotiable instruments.

57. Under paragraph 2, certain buyers or other transferees that obtain possession of a negotiable instrument acquire their rights in the instrument free of a security right that is effective against third parties by registration of a notice. More specifically, under paragraph 2, a buyer or other consensual transferee of a negotiable instrument can acquire its rights free of a security right in that instrument in either of two ways. First, under paragraph 2 (a), a person who becomes a protected holder or the like (the enacting State should insert the appropriate term in para. 2 (a)) of the negotiable instrument under the law of the enacting State acquires its right in the instrument free of an existing security right in it. Second, under paragraph 2 (b), a buyer or other transferee that takes possession of the instrument and gives value for it without knowledge that the sale or other transfer is in violation of the rights of the secured creditor also acquires its right in the instrument free of that security right. As with the rule in paragraph 1, this rule preserves the important role of possession in the law of negotiable instruments.

58. Knowledge of the existence of a security right does not prevent a buyer or other consensual transferee of a negotiable instrument from acquiring its rights in the instrument free of the security right under paragraph 2 (b) (although such knowledge may prevent the buyer from qualifying as a protected purchaser or the like and, thus, may prevent the buyer from taking free of the security right under paragraph 2 (a)). Rather, only knowledge that the transfer violates the rights of the secured creditor under the security agreement prevents the transferee from acquiring its rights in the instrument free of the security right under paragraph 2 (b). "Knowledge", as defined in article 2, subparagraph (r), means "actual knowledge". The reference to "good faith" that was included in recommendation 102 (b) has been deleted on the understanding that the absence of knowledge amounts essentially to good faith and the concept of good faith is used in the Model Law only to reflect an objective standard of conduct.

Article 47. Rights to payment of funds credited to a bank account

59. Article 47 is based on recommendations 103-105 of the Secured Transactions Guide (see chap. V, paras. 157-163). It determines the priority between competing security rights in a right to payment of funds credited to a bank account whether those rights to payment are original encumbered assets or proceeds of a security right in other property (according to art. 19, para. 1, a security right in proceeds in the form of a right to payment of funds credited to a bank account is automatically effective against third parties, if the security right in the original encumbered asset is effective against third parties). The rationale underlying the rules in article 47 is to avoid bringing the deposit-taking institution into violation of its obligations under other law.

60. Paragraphs 1-3, taken together, result in the conclusion that a security right in a right to payment of funds credited to a bank account made effective against third parties by any of the methods provided for in article 25 has priority over a security right made effective against third parties by registration of a notice in the Registry. Under paragraph 1, a security right in a right to payment of funds credited to a bank account that is made effective against third parties by the secured creditor becoming the account holder has priority over all competing security rights in the same asset. Next in priority order, paragraphs 2 and 3 give priority to: (a) a security right in a right to payment of funds credited to a bank account with respect to which the secured creditor is the deposit-taking institution; and (b) a security right made effective against third parties by a control agreement. Under paragraph 4, if there are multiple control agreements, priority is determined on the basis of the order of conclusion of the control agreements.

61. Under paragraph 5, except when the secured creditor has become the account holder, a security right in a right to payment of funds credited to a bank account is subordinate to the deposit-taking institution's rights under other law to set off claims against the grantor against its obligations to the grantor with respect to the grantor's right to payment of funds from the bank account. This rule protects deposit-taking institutions from losing their rights of set-off without their knowledge or consent.

62. Under paragraph 6, a transferee of funds from a bank account pursuant to a transfer initiated or authorized by the grantor acquires its rights free of a security right in the right to payment of funds credited to the bank account so long as the transferee does not have knowledge that the transfer violates the rights of the secured creditor under the security agreement. A "transfer of funds" includes transfers by a variety of mechanisms, including by cheque and electronic means. The purpose of paragraph 6 is to preserve the free negotiability of funds.

63. Knowledge of the existence of a security right does not prevent a transferee of funds from the bank account from taking free of the security right. Rather, it is only knowledge that the transfer violates the rights of the secured creditor under the security agreement that prevents the transferee from taking free. "Knowledge", as defined in article 2, paragraph (r), means "actual knowledge". Paragraph 7 is intended to preserve the rights of transferees of funds credited to a bank account under other law to be specified by the enacting State.

Article 48. Money

64. Article 48 is based on recommendation 106 of the Secured Transactions Guide (see chap. V, para. 164). Its purpose is to preserve negotiability of money. Thus, under paragraph 1, a transferee of encumbered money acquires its rights in it free of the security right, unless it has knowledge that the transfer violates the rights of the secured creditor under the security agreement. "Knowledge", as defined in article 2, paragraph (r), means "actual knowledge". Under paragraph 2, to preserve the negotiability of money, the rule of paragraph 1 should not adversely affect the rights of persons in possession of money under the relevant law to be specified by the enacting State.

Article 49. Negotiable documents and tangible assets covered by negotiable documents

65. Article 49 is based on recommendations 108 and 109 of the Secured Transactions Guide (see chap. V, paras. 167-169). It is designed to preserve current practices under which rights to the tangible assets covered (or represented) by a negotiable document are subsumed in the negotiable document with the result that parties that deal with the document generally need not concern themselves separately with claims to the assets not reflected in the document. Accordingly, under paragraph 1, a security right in a tangible asset made effective against third parties by possession of the negotiable document covering that asset is given priority over a competing security right made effective against third parties by any other means.

66. Paragraph 2 states an exception to that general rule. Except when the encumbered asset is inventory, it provides that the rule in paragraph 1 does not apply to a security right in an encumbered asset made effective against third parties before the asset became covered by the negotiable document or the time of conclusion of an agreement between the grantor and the secured creditor in possession of the negotiable document. The agreement must provide that the asset was to be covered by a negotiable document so long as the asset actually became covered by such a negotiable document within the time to be specified by the enacting State.

Article 50. Intellectual property

67. Article 50 is based on recommendation 245 of the Intellectual Property Supplement (see paras. 193-212). Its purpose is to clarify that the rule in article 34, paragraph 6, does not obviate other rights of the secured creditor in its capacity as an owner or licensor of the intellectual property that is the subject of the licence. This clarification is of particular importance because the concept of "ordinary course of business", used in article 34, paragraph 6, is a concept of commercial law and is not drawn from law relating to intellectual property and thus may create confusion in an intellectual property context. Typically, law relating to intellectual property does not distinguish in this respect between exclusive and non-exclusive licences and focuses rather on the issue whether a licence has been authorized or not.

68. As a result, unless the secured creditor authorized the grantor to grant licences unaffected by the security right (which will typically be the case as the grantor will rely on its royalty income to pay the secured obligation), the licensee would take the licence subject to the security right. Thus, if the grantor defaults, the secured

creditor would be able to enforce its security right in the licensed intellectual property and sell or license it free of the licence. In addition, a person obtaining a security right from the licensee will not obtain an effective security right as the licensee would not have received an authorized licence and would have no right in which to create a security right.

Article 51. Non-intermediated securities

69. Article 51 covers a topic not addressed in the Secured Transactions Guide, which excluded from its scope security rights in all types of securities (see rec. 4 (c)). So as not to interfere with existing customs and practices with respect to non-intermediated securities, this article adjusts the general priority rule of article 29 in a manner similar to the special priority rules for security rights in negotiable instruments and rights to payment of funds credited to a bank account.

70. For certificated non-intermediated securities, paragraph 1 provides that a security right made effective against third parties by the secured creditor's possession of the certificate has priority over a competing security right created by the same grantor that is made effective against third parties by registration of a notice in the Registry. This is parallel to the rule for negotiable instruments in article 46, paragraph 1.

71. For uncertificated non-intermediated securities, paragraph 2 provides that a security right made effective against third parties by registration in the books maintained for that purpose by or on behalf of the issuer has priority over a security right in the same securities made effective against third parties by any other method. Such registration may take the form of a notation of the security right or an entry of the name of the secured creditor as the holder of the securities in the issuer's books. The enacting State may choose the method that best suits its legal system. This rule is similar to the rule for rights to payment of funds credited to a bank account in article 47, paragraph 1. The rationale for this rule is that such notation or registration in the books of the issuer fulfils a similar function to the secured creditor becoming the account holder of a bank account.

72. Paragraphs 3 and 4 are also applicable only to uncertificated non-intermediated securities. They parallel the similar rules for rights to payment of funds credited to a bank account in article 47, paragraphs 3 and 4. Paragraph 3 gives priority to a security right made effective against third parties by conclusion of a control agreement over other security rights in the same securities. As between security rights made effective against third parties by conclusion of a control agreement, paragraph 4 awards priority in the order in which those control agreements were concluded.

73. Paragraph 5 is intended to preserve the rights of transferees of non-intermediated securities under other law to be specified by the enacting State. It parallels article 47, paragraph 7. Paragraph 5 recognizes that enacting States may have complex regimes that protect certain holders of non-intermediated securities under their law relating to the transfer of securities and that these regimes may diverge more widely than with respect to negotiable instruments and negotiable documents. Accordingly, unlike articles 46, paragraph 2, 47, paragraph 6, and 49, paragraph 3, that protect transferees of encumbered negotiable instruments, funds from bank accounts and negotiable documents, paragraph 5 of article 51 simply defers to those regimes.